1399 New York Avenue, NW
Washington, DC 20005-4711
Telephone 202.434.8400
Fax 202.434.8456
www.bondmarkets.com

360 Madison Avenue
New York, NY 10017-7111
Telephone 646.637.9200
Fax 646.637.9126

St. Michael's House
1 George Yard
London EC3V 9DH England
Telephone 44.20.77 43 93 00
Fax 44.20.77 43 93 01

June 29, 2005

Statement of
The Bond Market Association

Testimony Submitted to
The Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises
United States House of Representatives

Hearing on Legislative Solutions for the Rating Agency Duopoly

The Bond Market Association appreciates the opportunity to provide this statement for the record on competition in the credit rating industry. As you know, the Association represents securities firms and banks that underwrite, distribute and trade debt securities in the United States and internationally—a global market estimated at $44 trillion today. The Association speaks for the bond industry worldwide, advocating its positions and representing its interests in New York, Washington, London and elsewhere. The Association also works with bond issuers—companies, governments and others who borrow in the capital markets—and investors in fixed-income products from across the globe.

Our members account for approximately 95 percent of U.S. municipal bond underwriting and trading activity, all primary dealers in U.S. government securities as recognized by the Federal Reserve Bank of New York, and all major dealers in U.S. agency securities, mortgage- and asset-backed securities and corporate bonds, as well as money market and funding instruments. In recent years, the Association has sponsored both the American and the European Securitization Forums. These are affiliated organizations that focus on the rapidly growing securitization markets in the United States and Europe. Another Association-sponsored organization, the Asset Managers Forum, brings together institutions that are active in the bond market as investors to address major operational, accounting, public policy and market practice initiatives. The comments here reflect the collective views of the Association and our forums.

We welcome the opportunity to present this statement on the role of credit rating agencies in the capital markets and competition in the credit rating industry. We are also pleased to offer our comments on the Credit Rating Agency Duopoly Act (H.R. 2990), legislation that is clearly intended to change the competitive landscape in the credit rating industry. For several reasons which we articulate below, however, as currently drafted, H.R. 2990 could ultimately dilute the important role credit rating agencies play in the capital markets.

The past 15 years have seen dramatic growth in the number of issuers and the range and complexity of fixed-income securities. The importance of credit ratings to investors and other securities market participants has increased proportionally. The role of rating agencies is critical to the efficient functioning of the fixed-income markets. It is both important and useful for this committee to focus on an industry that plays such a vital role in the capital markets.

Credit Rating Agencies and the Fixed-Income Markets

All investments involve risk. One important type of risk associated with certain bonds and other fixed-income investments is credit risk—the chance that a bond will default, or the issuer will fail to make all interest and principal payments under the bond's terms. A credit rating is essentially an opinion offered by a rating agency on the credit risk of a bond. An investor can determine objective factors such as a security's coupon, maturity, call features and covenants from the issuer's public disclosures. Analysis of an issuer's credit quality, however, involves individual judgments about a variety of complex financial and other information. A credit rating is a valuable complement to an investor's own credit analysis precisely because it is both expert and independent. Credit ratings also guide the market's pricing decisions. Bonds with lower ratings are viewed as riskier than higher-rated bonds by investors who demand a yield premium as compensation for this risk. Conversely, higher-rated bonds will offer a relatively lower yield as a reflection of their stronger credit standing. In addition, ratings play an important role in market regulation.

To better appreciate the relationship between ratings and yields it is important to consider how the market prices bonds. With few exceptions, prices for fixed-income products are quoted as a number of basis points[1] over a benchmark such as U.S. Treasury securities of a comparable maturity, the London Interbank Offered Rate (LIBOR), the rate on interest rate swaps of comparable duration or some other benchmark that represents an investment perceived to be free of credit risk. The amount that the return on a given investment exceeds the return on the benchmark—a bond's "credit spread"—represents the risk premium investors receive as a result of the degree of risk, principally credit risk, the investment carries. Higher rated bonds have a smaller spread than lower rated bonds of the same maturity.

Why the Quality of the Rating Process Matters

Credit ratings have numerous market and regulatory implications for many market participants. Ratings determine borrowing costs for issuers of securities. They determine permitted investments for many types of investors, including insurance companies, mutual funds and banks. They also are used in determining the regulatory capital charges for different types of financial institutions, including broker-dealers

---

[1] One basis point equals 1/100th of a percentage point.

and banks. All of these uses for ratings have important regulatory implications. It is important that issuers, investors and financial institutions that use credit ratings for such regulatory purposes use only ratings issued by credit rating agencies that have demonstrated the ability to issue credible and reliable ratings. Otherwise, credit will not be properly allocated and priced, regulated investors with similar investment parameters will be able to invest in more risky securities without violating their investment restrictions, and banks and broker-dealers with similar risk profiles will maintain different capital levels. For this reason The Bond Market Association supports the NRSRO designation.

It is common for some institutional investors to have in-house rules limiting investment in any fixed-income security that does not have at least an investment grade rating.[2] Similarly, most states have laws dictating the permitted investments of insurance companies on the basis of credit rating. Some states require two ratings. The National Association of Insurance Commissioners (NAIC) maintains a list of rating agencies whose ratings are acceptable for this purpose.

Broker-dealers use credit ratings to supplement proprietary credit analysis. They also advise issuers of the effect of ratings on the cost of capital. Credit ratings, of course, are also important to investors with whom broker-dealers interact in the market place. In September 2004, the Corporate Debt Market Panel sponsored by the National Association of Securities Dealers (NASD) released a report recommending the disclosure of credit ratings immediately prior to an investor's decision to buy or sell a bond as well as upon confirmation of a trade.[3] This was followed in April 2005 by a proposal to require disclosure of credit ratings on retail bond confirmations.[4]

Credit ratings are also used in the regulation of broker-dealers and different types of institutional investors. One notable example is the Securities and Exchange Commission's net capital rule, which requires broker-dealers to maintain specified minimum capital levels to support their assets or customer liabilities. Since 1975, the net capital rule has imposed different capital charges for assets depending upon whether (and at what level) the assets are rated by what the SEC defined as a "Nationally Recognized Statistical Rating Organization" or NRSRO. Higher-rated securities receive a lower capital charge than lower-rated securities. Similarly, SEC-registered money market funds are permitted to invest in short-term debt securities

---

[2] An investment grade rating is defined as at least a BBB rating offered by Fitch Ratings or Standard and Poor's or a Baa rating offered by Moody's. A sub-investment grade rating, also known as high-yield or speculative grade, is defined as any rating below investment grade. Some institutional investors purchase a mix of investment grade and sub-investment grade bonds and some specialize in sub-investment grade exclusively.

[3] See Report of the Corporate Debt Market Panel (September 2004), available at http://www.nasd.com/web/groups/reg_systems/documents/regulatory_systems/nasdw_011445.pdf.

[4] See NASD Notice to Members 05-21 (March 2005)(Proposed Rule to Enhance Confirmation Disclosure in Corporate Debt Securities Transactions), available at http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_013616.pdf.

that receive one of the two highest NRSRO ratings. Investment grade ratings can also provide an issuer with the option of short-form SEC registration in some cases.

The Bank for International Settlement's Committee on Banking Regulation stipulates the use of credit ratings in assessing the capital charges for banks under the new Basel Capital Accord, Basel II. Basel II articulates a set of criteria a firm must satisfy in order to qualify as an External Credit Assessment Institution (ECAI) which allow its ratings to be used in this calculation.[5]

The NRSRO designation serves a unique purpose in SEC regulations for which a substitute is either not available or not practical. Using credit spreads or internal credit ratings as alternatives to NRSRO ratings for computing net capital requirements is possible, for example, but would add significant costs. In addition, in the case of internal ratings or ratings issued by rating agencies that have not been determined to produce credible, reliable ratings could result in the non-uniform treatment of the same assets by different firms.

The U.S. and European Regulatory Proposals

Recently, regulators in the U.S. and Europe have stepped up their focus on rating agencies and raised the prospect of changes in the current approach to regulatory oversight. In the U.S., the SEC recently published for comment proposed Rule 3b-10, which for the first time defines the term "nationally recognized statistical rating organization", sets forth some interpretations of the definition, and provides more clarity to the process by which a particular rating agency may apply for a no-action letter confirming that regulated entities may use its ratings as being provided by an NRSRO.[6] The Bond Market Association generally approves of the SEC's proposal and has provided technical comments (attached) on a number of the questions it poses.[7]

In response to queries from Members of Congress, the Commission has stated that it does not have the authority to regulate the activities of rating agencies.[8]

---

[5] *International Convergence of Capital Measurement and Capital Standards*, Basel Committee on Banking Supervision, June 2004. Page 35. The six criteria include objectivity, independence, transparency, disclosure, resources and credibility.

[6] See Definition of Nationally Recognized Statistical Rating Organization, Release No. 33-8570, 70 Fed. Register 21306 (April 25, 2005).

[7] See Comment Letter, dated June 9, 2005 from Marjorie E. Gross, SVP of The Bond Market Association, and Frank A. Fernandez, Senior Vice President of the Securities Industry Association, available at http://www.sec.gov/rules/proposed/s70405/bondmarket-sia060905.pdf.

.

[8] See, e.g. Testimony of Annette L. Nazareth, Director, Division of Market Regulation, U.S. Securities and Exchange Commission, before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, April 12, 2005.

In 2004, the International Organization of Securities Commissions (IOSCO), of which the SEC is a member, proposed principles (called "fundamentals") for codes of conduct for rating agencies.[9] The code principles are results-based rather than prescriptive. Publication of the IOSCO principles was followed by a request from the European Commission for public input on how the code of conduct principles should be implemented and a consultative paper issued by the Committee of European Securities Regulators (CESR) suggesting a range of regulatory approaches based on the IOSCO principles. In our comments to CESR, the Association stressed the need to avoid the creation of a detailed set of regulatory requirements after the initial certification.

TBMA Response to U.S. and European Regulatory Proposals

The Association's view on the regulation of credit rating agencies is simple:

- We believe that the criteria adopted by regulators for approving NRSRO's or ECAI's should be flexible enough to allow increased competition between a larger number of entities, while ensuring that designated rating agencies have the expertise to produce accurate ratings. In the U.S., this means eliminating the current requirement that a rating agency be widely recognized, rather than accepted in a defined sector of the market.

- We believe credit rating agencies should have policies and procedures to ensure the independence of the credit rating process. Some conflicts of interest should be prohibited. For example, rating agencies should have policies and procedures to prohibit the rating agency and analysts who rate the securities of particular companies from having an interest in the securities of such companies. Rating agencies should also have a policy that analyst compensation may not be related to the amount of revenue the rating agency derives from issuers that the analyst rates. However, many potential conflicts can be managed with disclosure and carefully crafted and enforced policies and procedures, and the regulators must be sensitive to the benefits of certain relationships that create potential conflicts of interest, including the funding sources and ancillary businesses of the rating agency.

- We believe credit rating agencies should publish their rating methodologies for various types of securities, so that both issuers and users will understand the agencies' requirements and standards, and so that different rating analysts in the same agency will produce consistent ratings.

- We believe rating agencies should make public, free of charge, ratings that are required by the rules of the SEC or self-regulatory organizations or used for regulatory purposes such as calculation of regulatory capital, and that rating agencies should have clear policies regarding permitted free use of their

[9] See the Technical Committee of the International Organization of Securities Commissions, Code of Conduct Fundamentals for Credit Ratings Agencies (December 2004), available at http://www.iosco.org/pubdocs/pdf/IOSCOPD180.pdf.

ratings and uses that constitute commercial use of the rating agency's intellectual property rights for which the rating agency may justifiably impose licensing fees.

- We do not believe that regulation of the credit rating process is necessary or desirable, since government regulation would tend to result in less diversity of opinion and would be less responsive to new product developments. Nevertheless, we do believe that to be designated an NRSRO, a rating agency should not use solely quantitative models and should request that an issuer's senior management participate in the rating process free of charge. There is substantial volatility in ratings based solely on quantitative models, and such ratings often give false positive results regarding credit problems. This causes us to conclude that ratings based solely on such models are not "credible, reliable" ratings.

- We believe issuers should be given an opportunity to correct factual misstatements in rating agency reports, but not to appeal rating designations outside the rating agency.

- We believe rating agencies should publish information on the historical accuracy of their rating assessments.

As the capital markets develop and mature globally, the need for a measured approach by regulators toward the conduct of rating agencies grows in importance. The Association does support those actions by regulators—such as modifying the criteria for NRSRO designation—that we believe will help enhance competition among rating agencies. We do not support steps that would limit the independence of rating agencies to determine their opinions of the creditworthiness of issuers. Furthermore, we do not support steps that would undermine the credibility and reliability of ratings.

The Association's position on the regulatory proposals dealing with the credit rating process in the U.S. and Europe is centered on the fundamental issues of competition and market conduct.

Competition

Some observers have questioned whether the credit rating industry is as competitive as it should or could be and have suggested that inappropriate barriers to entry exist. In the U.S., the nature of the NRSRO designation is often brought up as a factor in this debate. The Association supports the retention of this designation. We have also called for greater clarity in the SEC's approval policy and the elimination of the requirement that a rating agency be "widely accepted" in order to gain the designation. The Association certainly welcomes additional entrants to the marketplace from any part of the globe. Increasing competition among qualified rating agencies could only benefit issuers, investors and the market generally.

The SEC's proposed Rule 3b-10 does a number of things that should help to increase competition in the market for credit rating agencies. First, the increased transparency that will result from the adoption of the SEC's proposed Rule 3b-10 will aid public understanding of the process and improve the ability of other rating agencies to gain the NRSRO designation leading to enhanced competition in the industry. Rule 3b-10 specifically states that the SEC's test for "generally accepted in the financial markets as an issuer of credible and reliable ratings" includes acceptance for ratings in a particular industry or geographic segment. This will make it easier for new rating agencies to overcome barriers to entry by limiting the scope of their business to a particular industry or geographical area. Niche credit raters—after gaining experience and market acceptance—may then expand to cover a broader range of industries and securities.

At present, the SEC primarily considers whether an agency is "widely accepted" when deciding whether to grant NRSRO status. Proposed Rule 3b-10 characterizes the standard as being "generally accepted in the financial markets as an issuer of credible and reliable ratings ... by the predominant users of securities ratings." We understand that this standard has been criticized as creating a "Catch 22": a firm may have difficultly in being recognized as an issuer of credible and reliable ratings by the predominant users unless the SEC recognizes it by granting NRSRO status. The SEC's definition of NRSRO, however, defers to the market to identify the issuers of credible, reliable ratings, rather than assigning responsibility to the SEC to determine those ratings that are credible and reliable. Given the important regulatory uses of ratings, we believe that this "market acceptance" standard, although a high one, is warranted, and we urge Congress not to substitute its own judgment for the SEC's or the market's.

In Europe, CESR has listed barriers to entry that exist in the credit rating field and asked how regulators should address them. CESR recognized that much of the value the market assigns to credit ratings is based on reputation and track record, something new entrants necessarily lack. This dynamic, however, is not unique to the rating industry. CESR itself has described the barriers as "natural," and concluded that the barriers had not created a market failure or a condition in which a segment of issuers goes without service.

Rules of Conduct

The day-to-day operations of rating agencies should never be controlled by regulation. Specific rating methodologies and standards of due diligence should not be mandated by regulators. It is true that rating agencies in general tend to approach the rating process in similar ways – *e.g.* they group rating analysts by market, such as corporate, asset-backed or municipal bonds, and also industry or sector, such as financial services or transportation, and they make rating decisions by committee. As part of the process of gathering information, rating agency personnel attempt to maintain regular contact with issuers and rely on regulatory filings, news and industry reports. They also make use of nonpublic information, such as proprietary business forecasts.[10] However, it is important that no regulator mandate a particular methodology, as long as the rating agency can demonstrate that its own methodology produces credible and reliable ratings.

Similarly, while conflicts of interest between rating agencies, issuers and subscribers may exist, it would not be appropriate for regulators to prescribe specific methods for dealing with the issue. A more favorable approach—and one the IOSCO code now requires—would be for rating agencies to adopt policies and procedures to address and disclose potential conflicts of interest, such as issuer and subscriber influence and the potential misuse of public information.

The Credit Rating Agency Duopoly Relief Act

The recently introduced Credit Rating Agency Duopoly Relief Act, is clearly an attempt to eliminate barriers to competition in the credit rating industry. In pursuing the worthwhile goal of changing the competitive landscape, however, H.R. 2990 reflects some inaccurate assumptions about the industry and could ultimately dilute the important role credit rating agencies play in the capital markets. The following are our specific concerns with H.R. 2990:

Competition

- The question of competition is an important one. As noted above, the SEC did not create the barriers to entry for new participants. The industry is difficult to penetrate for new firms because much of the value the market assigns to particular credit ratings is based on reputation and track record, something new entrants necessarily lack. Unfortunately, in attempting to increase competition, H.R. 2990 makes it more likely that the quality of credit ratings will become less uniform.

Universal Registration

- H.R. 2990 creates a new category of "statistical rating organization," which is an entity whose primary business for the last three years has been the issuance of publicly available ratings. It also requires these rating agencies to register with the SEC. This is problematic for at least three reasons:

    - It is not clear why universal registration is desirable if a rating agency produces ratings on companies or securities that are not used for regulatory purposes.

    - An organization whose primary business is the issuance of publicly available ratings that are used for regulatory purposes but that has been in existence less than three years would not be required to register. The reason for this exclusion is not evident.

[10] This information is provided under a promise of confidentiality and under an exemption from the Securities and Exchange Commission's (SEC) Regulation FD. The Association strongly supports maintaining this exemption.

- The definition of publicly available ratings is both too narrow and too broad. It is too narrow because a rating would only be deemed to be public if disseminated on the internet. There is no reason that the definition should be so limited. Public ratings used for regulatory purposes could be published using other means (e.g. in newspapers). It is too broad because it would require registration of certain companies that produce credit research for no apparent reason. For example, a rating disseminated to a small group of institutional investors over the internet for a fee on a password-protected basis would be considered to be "public", even if not used for regulatory purposes. Similarly, the definition could be read to include research firms that produce investment research reports with "buy-sell-hold" recommendations. There is no obvious reason for registration of issuers of such ratings.

- Today, rating agencies are not required to register unless their customers want to use the ratings for regulatory purposes. Some firms that provide credit reports with ratings have chosen not to apply for NRSRO status, because their ratings are provided only to institutional investors who want them for their analysis and not for regulatory purposes. H.R. 2990 requires these firms to register, although it would allow the SEC to exempt them from the registration requirements. This turns the current regulatory system on its head. Instead of only a few firms applying to be NRSRO's, many firms that provide credit analysis would have to register or apply for an exemption.

- It is not clear who would have to register under H.R. 2990 because the term "ratings" is not defined. Since ratings may include ratings on either companies or securities, credit research firms who publish buy-sell-hold ratings would all be required to register as NRSROs.

Ratings of securities versus ratings of companies

- Under H.R. 2990, a rating would include a rating on either companies or specific securities. Many companies issue a variety of securities with different terms, subordination, covenants and collateral. A rating of a company is not necessarily meaningful with respect to particular securities issued by the company.

Ratings based solely on quantitative methodology

- Under H.R. 2990, the definition of "statistical rating organization" includes an organization that employs either a quantitative or qualitative model, or both, to determine ratings. As noted above, the Association does not favor granting the NRSRO designation to firms that use solely quantitative models and do not request that an issuer's senior management participate in the rating process free of charge. There is substantial volatility in ratings based solely on quantitative models and such ratings often give false positive results regarding credit problems. This causes us to conclude that ratings based solely on such models are not "credible, reliable" ratings.

Public availability of ratings

- The SEC and IOSCO rules[11] with respect to NRSROs mandate that ratings used for regulatory purposes must be disseminated to the public free of charge. (The report that provides the rationale for the rating need not be disseminated free of charge. The rating agency may thus profit from selling subscriptions to its rating reports.) H.R. 2990 states that a rating will be considered to be "publicly available" if it is disseminated either for free or for a fee. It does not even require that any fee be reasonable. As noted above, The Bond Market Association believes that credit rating agencies should make public, free of charge, ratings that are required by the rules of the SEC or self-regulatory organizations or used for regulatory purposes such as calculation of regulatory capital, and that rating agencies should have clear policies regarding permitted free use of their ratings and uses that constitute commercial use of the rating agency's intellectual property rights for which the rating agency may justifiably impose licensing fees.

Registration versus recognition

- H.R. 2990 involves registration, but not "recognition" of rating agencies. Under the bill, rating agencies would be required to provide information concerning the rating agency and its associated persons, conflicts of interest, rating methodologies, ratings performance measurement statistics, and procedures to prevent the misuse of nonpublic information. However, the bill contains no "merit-based" criteria for granting or denying an application. Rather, the Commission is instructed to grant the registration if it finds that "the requirements of this section" are satisfied, *i.e.,* if the rating agency has filed the necessary disclosures. As noted above, we believe that the regulatory purposes of "recognition" of rating agencies is crucially important. Consequently, we believe the decision to grant or deny "recognition" or "registration" should be merit-based. In addition, because the SEC does not have the same level of expertise in judging the credibility and reliability of ratings, we do not think it unreasonable for the SEC to have determined to use as its benchmark whether the principal users of ratings recognize the value of such ratings by subscribing to them. Finally, because we believe in the importance for regulatory purposes of a merit-based selection process, as noted above, we disagree with the proposal in H.R. 2990 to eliminate the designation.

Investment Advisers Act registration

- H.R. 2990 requires rating agencies that are registered under Section 203 of the Investment Advisers Act to withdraw from registration. Congress could certainly conclude that rating reports are credit opinions and not investment advice and that registration under the Investment Advisers Act is not required. It is not clear, however, why rating agencies should not be able voluntarily to register as

---

[11] See the SEC's website. http://www.sec.gov/rules/proposed/33-8570.pdf

investment advisers should they choose such a designation, especially if the market perceives that registration under the Investment Advisers Act confers additional benefits to users of ratings.

Anti-competitive practices

- H.R. 2990 requires the SEC to adopt rules "to prohibit specific anti-competitive practices common to the statistical rating organization industry." The purpose of granting anti-trust jurisdiction to the SEC is unclear. Other federal agencies, including the Department of Justice and the Federal Trade Commission, already have jurisdiction over anti-competitive practices and possess expertise in the enforcement of the anti-trust laws. If the SEC is to be given anti-trust jurisdiction, it should be to prohibit anti-competitive practices. The SEC should not have to prove that such practices are "common to the statistical rating organization industry."

- The Association supports the concept advanced in H.R. 2990 of requiring the SEC to adopt provisions regarding conflicts of interest, a firm's ratings methodology, and the publication of ratings performance measures and procedures.

Conclusion

The Association is pleased to offer the above comments on credit rating agencies and H.R. 2990. As we have noted, the credit rating industry plays an important and unique role in the capital markets. Regulators can best ensure the twin goals of increased competition and credible, reliable ratings by (1) retaining the NRSRO designation for rating agencies whose ratings are used for securities regulatory purposes, (2) adopting clear requirements for the designation of NRSROs, (3) encouraging all rating agencies to adhere to the principles enunciated in the IOSCO Code Fundamentals for Rating Agencies, and (4) ensuring that the SEC has the authority to examine NRSROs to ensure that they continue to meet the requirements for designation as NRSROs and adhere to a code of conduct that complies with the IOSCO code principles but does not dictate specific methodologies for determining ratings.

The Bond Market Association
360 Madison Avenue
New York, NY 10017

Securities Industry Association
1425 K Street, NW
Washington, DC 20005

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549
Attn: Jonathan G. Katz, Secretary

June 9, 2005

Re: Definition of Nationally Recognized Statistical Rating Organization; File No. S7-04-05

Ladies and Gentlemen:

The Bond Market Association (the "BMA")[1] and the Securities Industry Association (the "SIA"[2] and, together with the BMA, the "Associations") welcome the opportunity to comment on the proposed new rule published by the Securities and Exchange Commission (the "Commission" or the "SEC") under the Securities Exchange Act of 1934, which would define the term "nationally recognized statistical rating organization" ("NRSRO").

The Associations have been and continue to be active participants in the debate concerning credit ratings agencies. The BMA has written a number of comment letters on the U.S. and European proposals regarding credit rating agencies.[3]

---

[1] The Bond Market Association is an international trade association representing approximately 200 securities firms and banks that underwrite, distribute and trade in fixed income securities in the U.S. and internationally. More information about the BMA and its members and activities is available on its website www.bondmarkets.com.

[2] The Securities Industry Association brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA members, including investment banks, broker-dealers and mutual fund companies, are active in U.S. and foreign markets and in all phases of corporate and public finance. More information about the SIA and its members and activities is available on its website www.sia.com.

[3] See, e.g. Comment letter, dated January 28, 2005, from the BMA to the Committee of European Securities Regulators ("CESR") on CESR's technical advice to the European Commission on possible measures concerning credit rating agencies (Consultation Paper of November 2004), available at http://www.bondmarkets.com/assets/files/CESR%20CP%2030%20Nov%2004%20-%20Final.pdf; Letter, dated November 6, 2004, from the BMA on the Report of the Chairmen's Task Force of the

The Associations applaud the Commission for its thoughtful approach to bringing more clarity and transparency with regard to the NRSRO concept. This letter will give our views on some of the issues raised by the Commission in the proposing release (the "Release"), specifically:

1. **Public Availability**. The Commission has asked how it should be determined whether an NRSRO is making its credit ratings readily available on a widespread basis. We do not believe the commission should limit the means by which rating agencies disseminate their ratings, since there are undoubtedly many ways in which such disseminations could be effected. Nevertheless, we believe it would be appropriate for the Commission to state that internet posting alone would be sufficient, since the vast majority of investors in rated securities have access to the internet.

The Release also mentions the issue of whether a credit rating agency should be required to disclose ratings to the public when the rating agency has prescribed conditions for not publishing the issuer's ratings (e.g. in the case of "private" ratings provided only to the issuer). The Release contains an interpretation that "publicly available" means that ratings used for regulatory purposes must be disseminated on a widespread basis. We support this interpretation, as it applies to the use of ratings for SEC regulatory purposes. However, we understand that investors often request private ratings of unrated securities or obtain a credit enhancement for a rated security and then obtain a private higher rating. If another regulator (e.g. the NAIC) is willing to allow an investor (e.g. an insurance company) to use such a rating for regulatory (e.g. permitted investment) purposes, even if the rating is not made public, we do not believe the rule should make the issuer of such a private rating ineligible for NRSRO status merely because it provides a private rating.[4]

2. **Requirement to rate specific securities**. We agree with the requirement that an NRSRO rate specific securities and not provide solely entity ratings. Many bond issuers have several different classes or issues of outstanding debt obligations with varying maturities and structures. Those issues often have different rights, depending on the terms under which they were issued, including different call features, covenant packages, seniority or subordination in the corporate capital structure, collateral, guaranties and other economic attributes. Consequently, publication of a single issuer rating could be misleading. It should be made clear that an NRSRO may also issue company specific assessments, such as "default predictors."

Technical Committee of the International Organisation of Securities Commissions regarding a Code of Conduct Fundamentals for Credit Rating Agencies, available at http://www.bondmarkets.com/assets/files/Response%20to%20IOSCO%20Final%20-%20Clean.doc; Letter, dated August 5, 2004, from the BMA to the Committee of European Securities Regulators, responding to CESR's call for evidence on Possible Measures Concerning Credit Rating Agencies, available at http://www.bondmarkets.com/assets/files/CESR%20Call%20-%20BMA%20comment%20letter.pdf ; Letter dated July 28, 2003 from John M. Ramsey to Jonathan G. Katz on Credit Rating Agency Concept Release (see Release footnote 48).

[4] See, for example, Technical Committee of the International Organization of Securities Commissions, Code of Conduct Fundamentals for Credit Rating Agencies (December 2004)(hereinafter "IOSCO Code Fundamentals", Section 3.4 which states "Except for 'private ratings' provided only to the issuer, the CRA should disclose to the public, on a non-selective basis and free of charge, any rating regarding publicly issued securities . . . if the rating action is based in whole or in part on material non-public information."

3. **Current Assessment Requirement**. The proposed definition requires a rating to be a "current" assessment." This, in turn, would require the rating agency to have and follow procedures designed to ensure that its ratings are reviewed and, if necessary, updated on the occurrence of material events. We agree that this requirement is desirable. We also agree, however, that the Commission should not prescribe a specific time period within which an NRSRO's ratings would need to be updated, since the appropriate time will vary from security to security. We believe that some NRSROs have begun to publish lists of securities ratings, along with the date of the most recent rating/rating report. We believe this should be encouraged. We also believe the Commission should address the update requirement with respect to private ratings. We understand that at least one rating agencies does not update private ratings, and that some ratings are designed for a particular purpose and would not need updating.[5]

4. **Nationally recognized**. In determining whether to issue a no action letter, the Staff has considered the single most important factor to be whether the credit rating agency is "nationally recognized" in the United States by the predominant users of securities ratings as an issuer of credible and reliable ratings. The Proposed Rule's standard is whether a credit rating agency is "generally accepted in the financial markets as an issuer of credible and reliable ratings by the predominant users of securities ratings." The staff believes that this "recognition" or "acceptance" is a proxy for whether ratings are credible and reliable and can reasonably be relied upon in the marketplace.

The Release proposes two ways that a rating agency could meet this component of the NRSRO definition: (1) statistical data that demonstrates market reliance on the credit agency's ratings such as, market movements in response to ratings changes, and (2) attestations by authorized officers of users representing a "substantial percentage of the relevant market" that the credit rating agency's ratings are credible and actually relied upon by them. It also asks whether other types of information would be appropriate, such as the fact that a rating agency has many subscribers, or the views of issues.

We believe it is very difficult to measure "reliance" on ratings. Many ratings do not involve upgrades and downgrades and therefore may not produce market movements. Moreover, market movements in response to ratings changes may be difficult to attribute solely to a particular rating change, if the change is made in response to issuer developments and is made at the same time as the public announcement or the same time other rating agencies are taking similar action. Either attestations by authorized officers of users or the number of subscribers willing to pay for the rating agency's research reports would be a much more objective measure.

We believe the requirement of attestations from users representing a "substantial percentage of the relevant market" needs further clarification. For example, clarification is required with regard to how to determine what is the relevant market

[5] See IOSCO Code Fundamentals, Section 1.9, which states "Except for ratings that clearly indicate they do not entail ongoing surveillance, once a rating is published the CRA should monitor on an ongoing basis and update the rating . . . ." (emphasis supplied).

for a particular security, e.g., whether that market is defined geographically or by common characteristics of investors or dealers. Additional clarification is needed with regard to what percentage is considered substantial, e.g. 10%? 20%?, and what metric should be used to calculate that percentage, e.g., the number of users or the amount of assets they own or manage.

Finally, we believe that, if the purpose of this test is as a proxy for whether ratings are credible and reliable and whether they can reasonably be relied upon in the marketplace, then the views of issuers may not be meaningful and may be subject to conflicts of interest.

5. **Limited Sector/Geography Recognition**. We applaud the Commission's decision to recognize that the definition of NRSRO should include credit rating agencies that confine their activities to limited product or geographic sectors. We believe that there are valid arguments that, once an agency is recognized for issuing credible and reliable ratings within a limited sector or geographic area, it should meet the NRSRO definition without product or geographic limitation ("broad recognition"). There are also valid arguments on the other side ("narrow recognition"). However, we believe the balance favors broad recognition. First, this will enable relatively new entrants to build out their businesses, and will help to lower what has been a barrier to new entrants into the market. Second, once a firm has demonstrated the ability to publish credible, reliable ratings in one area, it has proved its expertise in credit risk assessment, and, thus, its ability to produce credible ratings in other areas. Third, using broad recognition avoid the problem of distinguishing ratings that are considered to be issued by an NRSRO from those that are not, particular when the Commission prohibits NRSROs from disclosing that they are NRSROs. Finally, it levels the playing field with existing NRSROs, which do not have to obtain Commission permission before beginning to rate new types of securities. The argument for narrow recognition, of course, is that the Commission's test for "nationally recognized" is that the rating agency is generally accepted in the financial markets as an issuer of credible and reliable ratings by the predominant users of securities ratings. General recognition for a particular expertise does not necessarily equate to acceptance in other areas. On balance, however, we believe this should be a matter for determination when the NRSRO's designation is being reviewed.

6. **Analyst Experience and Training**. The ability to identify, understand and analyze data from and about issuers is clearly crucial to credit rating agencies. The Proposal contains a number of recommendations with respect to workload and training of "analysts" and other staff, but does not define the term "analyst." Consequently, it is not clear whether the proposal is limited to persons who are responsible for recommending ratings, or would apply to all rating agency staff who perform any kind of financial or credit analysis. We believe a definition of "analysts" would be helpful, and that the definition of Research Analyst in Regulation AC, which depends on the definition of a Research Report and focuses on those primarily responsible for the preparation of reports could be used as a model. Such a definition would recognize that the ratings process is a team and committee process. Consequently, every person on the team may not have the same level of competence.

What is important is that the rating agency has procedures for ensuring that the persons actually responsible for the report have the required experience and competence and are responsible for delegated work.[6] We also believe that an NRSRO should have policies and procedures in place to ensure compliance with requirements for the qualifications, experience, workload and performance of its ratings staff.

7. **Number of Ratings Per Analyst**. We do not support a Commission-imposed limitation on the number of ratings per analyst. The right number of ratings will depend on the nature of the securities being rating, the complexity of the issuers, and the resources available to the analysts, among other things. We believe, however, that disclosure by an NRSRO of the number of credit analysts they employ and the average number of issues rated or otherwise followed would be salutary.

8. **Ratings Relying Primarily on Quantitative Models**. We do not believe that a rating agency that uses solely quantitative models and does not request that an issuer's senior management participate in the rating process free of charge should be designated an NRSRO. There is substantial volatility in these ratings and they often give false positive results regarding credit rating problems. However, ratings based solely on quantitative information may have their place and be useful for investors and others. For example, Moody's KMV RiskCalc Model is based solely on quantitative factors. It does not actually assign a rating, but rather an expected default frequency, which can then be easily correlated to a certain rating level. Nevertheless, we believe there is a substantial difference between ratings that rely primarily on quantitative models and those that include extensive contacts with the issuer's management, and that the former should not be the only ratings relied upon for regulatory purposes. If the Commission determines not to exclude firms relying primarily on quantitative models from NRSRO designation, we believe a rating agency that relies primarily on such models should provide clear disclosure that its ratings are based solely on quantitative factors.

9. **Conflicts of Interest**. The Release states that the examination of NRSROs or comment letters on the Commission's 2003 concept release on rating agencies (the "Concept Release")[7] revealed a concern with potential conflicts of interest, including (1) potential conflicts created when issuers pay for their ratings; (2) conflicts due to the marketing by NRSROs of ancillary services to issuers, such as pre-rating assessments and corporate consulting; (3) giving subscribers preferential access to rating analysts; and, (4) unsolicited ratings.

We agree that ratings should not be unduly influenced by a person with a vested interest in the level of the rating. For that reason, we believe rating agencies should have policies and procedures to prohibit the rating agency and analysts who rate particular companies from owning securities in those companies.[8] However, we

---

[6] Compare IOSCO, Code Fundamentals, Section 1.4 ("the CRA should use people who, individually or collectively have appropriate knowledge and experience in developing a rating opinion for the type of credit being applied.")

[8] See, e.g. IOSCO Code Fundamentals, Section 2.9 (The CRA and its employees should not engage in any securities or derivatives trading presenting conflicts of interest with the CRA's rating activities).

believe it is important to determine whether potential conflicts are likely to have an adverse effect on the independent judgment of analysts. Moreover, we do not agree that all the listed potential conflicts are actual conflicts that should be eliminated rather than managed. We also believe it is salutary for rating agencies to have a policy that analyst compensation will be unrelated to the amount of revenue the rating agency derives from issuers that the analyst rates.[9] Similarly, we believe rating agencies should prohibit an employee from participating in the rating process for an issuer if the employee has had recent employment or another significant business relationship with the rated entity or has an immediate relation (e.g. a spouse, partner, parent, child or sibling) who currently works for the rated entity. We understand that the Commission believes that its authority to regulate the practices of NRSROs is limited. However, the topic of analyst conflicts seems no less important than the ratio of companies covered.

We agree that unsolicited ratings raise sufficient concerns that credit rating agencies should have procedures designed to avoid employing improper practices with respect to unsolicited ratings and to verify compliance with those procedures. We do not believe, however, that unsolicited ratings are per se manipulative or that they should be banned.

We do not believe that the fact that issuers often pay for ratings creates a per se conflict of interest. Rating agencies must please a number of different constituencies, including not only issuers, but also investors and investment bankers. In addition, we believe rating agencies value their reputations for accuracy and trenchant analysis. Consequently, we believe the disclosure of the source of any payments for the rating is sufficient to put users on notice of any potential conflict.

The question of ancillary services is one that should be closely evaluated. Credit rating agencies do not currently provide the same level of ancillary services that were provided by accountants before such services were limited by law and regulation. In addition, we believe that many services that might be considered "ancillary" to the "ratings" business are actually either an integral part of the ratings business or should be seen as complementary and not conflicting. Consequently, we believe that any risk that performance of such services will have an adverse effect on the independence of the judgment of the ratings analyst may be managed with policies and procedures adopted by the rating agencies. Requiring the complete separation of "rating services" from so-called ancillary services may have a substantial negative effect on the cost of implementing Rule 3b-10. In this regard, we note that the IOSCO Code Fundamentals only require that a rating agency separate its credit rating business and analysts from other businesses of the rating agency *that may present a conflict of interest*.[10]

For example, we believe that rating assessments or evaluation services ("RAS/RES") are not ancillary services or consulting services, but are core rating products. They

---

[9] See IOSCO Code Fundamentals, Section 2.11, which proposes that the CRA's code of conduct should state that a CRA analyst will not be compensated or evaluated on the basis of the amount of revenue that the CRA derives from issuers that the analyst rates or with which the analyst regularly interacts.

[10] See IOSCO Code Fundamentals Section 2.5.

involve communicating to issuers that a proposed structure of a hypothetical security would receive a designated rating. Nothing about provision of the rating assessment should affect the judgment of the analyst in recommending an actual rating. Consequently, any requirement to separate the staff advising issuers as to a proposed rating from the rating analysts who actually rate such products would needlessly produce increased cost for both issuers and rating analysts. Potential conflicts of interest can be adequately controlled if rating analysts are not allowed to market the rating agency's services and are not informed whether a prospective rating customer was solicited for other types of business.

Similarly, Moody's KMV RiskCalc model is probably not a rating product within the meaning of the Release, since it is not security-specific and does not produce ratings within a specific number of ratings categories, although the expected default frequencies produced by the model can easily be correlated to a certain rating level. Yet we see no reason why the provision of such expected default frequencies should be viewed as inconsistent with the rating business. It is based on the same underlying information and is a complementary service.

Another example of a complementary service is the provision of insurance company payment ratings. They are different from credit ratings, but sufficiently similar that they pose no risk to the judgment of a single rating staff.

Along the same lines, if a credit rating agency were to establish a business to perform continuous due diligence on issuers of debt securities in order to aid underwriters in performing due diligence in connection with underwritings, we believe it would be counterproductive if the Commission's rules required that such business be performed only by employees separated by information walls from the rating analysts. The information required by the rating agency to perform these functions would be the same. The expertise required of the rating agency staff would be the same. The engagements would be complementary. As in the case of RAS/RES services, we believe rating analysts should not market such services, but we see no problem with their performing them.

10. **Financial Resources**. We agree that an NRSRO should have the financial resources necessary to ensure that it can comply with its rating procedures and to monitor continuously the financial condition of the issuers of the securities it rates. In our opinion, an NRSRO should make its audited financial statements available to users of its ratings so that they can assess whether the NRSRO meets this requirement. We do not think an NRSRO should be required to provide users of ratings with information relating to the percentage of revenue it receives from all issuers or subscribers, but we would support a requirement for disclosure of issuers or subscribers from whom NRSRO's receive more than a specified proportion of their revenues, e.g. 5%, so that such users can assure themselves that the NRSRO is finally independent of its large subscribers and issuers. We would not favor limiting the percentage of revenues an NRSRO receives from a single issuer or subscriber. We believe that the existence of such concentrations should be considered by the SEC in determining whether to approve or re-approve designation as an NRSRO. However, the effect of such concentrations may vary by market and it will be important for the

Commission to apply its own judgment in determining whether such concentrations are likely to affect the NRSRO's independent credit judgment.

11. **Other issues**. Although the Release cites, in footnote 55, the IOSCO Code Fundamentals, it does not state the extent to which other issues addressed in the IOSCO Code Fundamentals, or rating agency codes of conduct that comply with the IOSCO Code Fundamentals, will be treated in determining compliance with the Commission's 3-pronged test for NRSRO designation. For example, the IOSCO Code Fundamentals require (1) that a credit rating agency use rating methodologies that are rigorous, systematic and, where possible, result in ratings that can be subjected to some form of objective validation based on historical experience; (2) that analysts should use methodologies established by the rating agency and should apply a given methodology in a consistent manner; (3) that credit ratings should be assigned by the agency and not by any individual analyst; and (4) that rating agencies have a policy that they not forbear or refrain from taking a rating action based on the potential effect (economic, political or otherwise) of the action on the rating agency, an issuer, an investor, or other market participants. These are all factors that the Commission should consider in determining whether to grant or renew NRSRO status.

12. **The Interpretations**. We believe it would be useful for the final Rule 3b-10 to include the interpretations of the components of the definition discussed in the Release. Although the release is relatively short, it contains much information other than the interpretations, and, over time, the interpretations will be more difficult to find. Given the concerns about barriers to entry into the credit rating agency business, we believe that the Commission should help potential new entrants by maintaining the relevant interpretations in a readily accessible place, such as in or accompanying the rule.

13. **More Substantive Regulation of Credit Rating Agencies**. The IOSCO Code Fundamentals have only recently been put into place. The major credit rating agencies have adopted Codes of Conduct to meet the IOSCO requirements. We believe the Commission should allow more time to determine whether those Codes of Conduct are working before seeking extensive new regulatory powers over credit rating agencies. As the Release points out, many commenters on the Concept Release supported the concept of regulatory oversight of NRSROs solely to allow the Commission to determine whether a credit rating agency continued to meet the NRSRO criteria on an ongoing basis. We believe the Commission either has or should have the authority to determine whether a rating agency meets or continues to meet the requirements for designation as an NRSRO. We do not, however, believe that more extensive regulation of rating agencies is warranted. We urge the Commission to allow the market to police the rating agencies and not to attempt to impose new regulatory burdens that will attempt to substitute the Commission's judgments for those of the market.

The Associations thank the Commission for this opportunity to comment on the proposed rule and Release. If you have any questions on these comments, please feel free to contact Marjorie Gross of The Bond Market Association at 646.637.9204 or mgross@bondmarkets.com or Frank Fernandez from the Securities Industry Association at 212-618-0517 or ffernandez@sia.com.

Very truly yours,

Marjorie E. Gross
Senior Vice President and Regulatory Counsel

Frank A. Fernandez
Senior Vice President and Chief Economist